In the

United States Court of Appeals

For the Ninth Circuit

HARVEY L. WELLS and HARRY J. ALBERTSEN, on behalf of themselves and others similarly situated, *Appellants,*

vs.

J. C. PENNEY COMPANY, a corporation, and THE CHASE MANHATTAN BANK, a corporation (substituted for The Chase National Bank of the City of New York), *Appellees.*

NO. 15,125

APPELLANT'S BRIEF

Appeal from Final Judgment of the United States District Court for the District of Oregon.

HONORABLE GUS J. SOLOMON, JUDGE

KING, MILLER, ANDERSON, NASH & YERKE
RALPH H. KING
FREDERIC A. YERKE, JR.
PAUL R. MEYER
American Bank Building
Portland 5, Oregon
Attorneys for Appellants.

KOERNER, YOUNG, McCOLLOCH & DEZENDORF
CLARENCE J. YOUNG
WAYNE HILLIARD
800 Pacific Building
Portland 4, Oregon

W. H. DANNAT PELL
HENRY STONE
522 Fifth Avenue
New York 36, N.Y.
Attorneys for Appellees

DAILY JOURNAL OF COMMERCE

INDEX

INDEX

INDEX

PAGE

ARGUMENT

TABLE OF CASES AND AUTHORITIES

CASES

PAGE

TEXTBOOKS

STATUTES

In the

United States Court of Appeals

For the Ninth Circuit

HARVEY L. WELLS and HARRY J. ALBERTSEN, on behalf of themselves and others similarly situated, *Appellants,* vs. J. C. PENNEY COMPANY, a corporation, and THE CHASE MANHATTAN BANK, a corporation (substituted for The Chase National Bank of the City of New York), *Appellees.*	NO. 15,125

APPELLANT'S BRIEF

Appeal from Final Judgment of the United States District Court for the District of Oregon.

HONORABLE GUS J. SOLOMON, JUDGE

STATEMENT OF JURISDICTION

The complaint filed July 11, 1951, alleged a controversy which exceeded the sum of $3,000 exclusive of interest and costs and which was between citizens of different states (R. 4), thus giving the District Court jurisdiction pursuant to 28 U.S.C.A., Section 1332.

On June 7, 1954, the District Court heard preliminary arguments on issues of jurisdiction. The District Court subsequently ruled that the action was properly maintainable as a class action under Rule 23 (a) of the Federal Rules of Civil Procedure (R 248-250) and that the Trustee adequately represented the Trust, thereby making joinder of other participants as parties defendant unnecessary under Rule 19 of the Federal Rules of Civil Procedure (R. 250).

The action was tried on June 23 and 24, 1954 (R. 261). On December 29, 1955, the trial judge issued his decision. Findings of fact, conclusions of law, and final judgment were entered by the court on March 8, 1956 (R. 215, 254). Notice of appeal was filed April 5, 1956 (R. 256). This court has jurisdiction to hear this appeal by virtue of 28 U.S.C.A., Section 1291.

STATEMENT OF THE CASE

A. Preliminary Statement

This is a case of great importance to numerous persons. It is also a case the facts of which are not easily assimilated.

The persons involved were formerly either (1) managers of stores of J. C. Penney Company or (2) members of the management staff of that corporation. These individuals were forced by their employer to become par-

ticipants in a so-called "Profit-Sharing Retirement Plan." Their earnings and compensation were used to purchase 200,000 shares of the stock of J. C. Penney Company (later split 3 for 1). However, because of the provisions of the "Plan" each of such persons was subject to being disqualified from receiving even one share of such stock by the occurrence of any one of a number of events. Thus, a manager who was forced to resign because of ill health prior to attaining the retirement age of 60 received no stock. Similarly, the estate of a manager who died one day before reaching the age of 60 received no stock. A manager who was discharged without cause one day before reaching the age of 60 also received no stock.

Not only were participating employees deprived of any portions of the stock upon the occurrence of events such as those enumerated above, but also because of the provisions of the "Plan" the occurrence of such events increased the amount of stock to which the remaining participants became entitled.

The "Plan" thus imposed by J. C. Penney Company upon its employees was by its own admission unique and without parallel in this country. The uniqueness of the "Plan" may be attributed to a great extent to the fact that (1) participants stood to benefit from the predecease of fellow participants in whom they had no in-

surable interest and (2) the method for awarding the stock embraced the very elements which the courts have traditionally found present in schemes outlawed as lotteries or wagering contracts. Condemnation by the courts of such schemes has occurred despite avowed legitimate business purposes and despite alleged good intentions of the sponsors.

This action was instituted as a class action by two members of the group to which reference has been made. This court is asked to recognize that the stock in question is held under a resulting trust for those whose contributions and earnings were used to purchase the same.

B. Summary of Facts

1. Establishment of Plan

Effective January 1, 1940, appellee J. C. Penney Company, hereinafter referred to as "Company," established its Profit-Sharing Retirement Plan (for Management Staff), hereinafter referred to as "Plan" (R. 14-41). Appended to the Plan as "Exhibit A" was a Trust Agreement (R. 41-75) entered into by Company on July 8, 1940, with appellee The Chase National Bank of the City of New York for whom appellee The Chase Manhattan Bank of the City of New York has been substituted R. 214), hereinafter referred to as "Trustee."

The Trust provided that the Trustee hold, administer and disburse all funds and shares of stock accumulated under the Plan. The Plan was expressly devised as a substitute for the previous practice of making available for sale to managerial personnel "expansion stock" in the Company (Exhibits 2 and 55).

The Penney Company could, while the Plan was in effect, discharge a store manager or any other participant without cause (R. 178). At the same time every eligible manager or executive was compelled to participate in said Plan as a condition of continued employment with the Company (R. 302).

2. Purchase of Stock by Trustee

Under Section 5 of the Plan (R. 20), Company agreed to sell to Trustee 200,000 shares of the authorized unissued common stock of Company (book value on January 1, 1940, of approximately $29.32 per share (Exhibit 145) for $30 per share.

The sale of Penney stock to Trustee was completed at the outset of the Plan. According to the Company's "Explanatory Reference to Proposed Plan," paragraph "5" (Exhibit 2): "Under Delaware laws, the company * * * [could not] sell this stock without receiving payment in full for same at the time of sale." Not only did the law permit only an outright sale, but also the Company in this same paragraph "5" indicated the consid-

erable benefit to it by such sale, compared to some other retirement plan:

> "In such a [n annuity] plan, however, there would ordinarily be some substantial outlay involved for older service eligibles. Under this plan, however, the company would have available for investment a sum of about $5,500,000 representing the selling price of the stock. Considering only such amount, it appears we should anticipate some earning power by the use of same in the company's business even though the earnings might not average as high as the company's present rate of earnings on its capital. To offset the disadvantages of the tax non-deductibility [because of sale for value], the return on the $5,500,000 would need be only slightly in excess of 3½%." (Exhibit 2)

In order to pay for said shares of stock, the Trustee obtained a loan from Continental Illinois National Bank and Trust Company of Chicago, hereinafter referred to as "Bank," and pledged said shares of stock as collateral (Exhibits 210 and 211). The 200,000 shares of Penney stock bought by the Trustee were divided into two blocks, one of 50,000 shares and one of 150,000 shares. On January 16, 1946, J. C. Penney stock was split 3 for 1 (R. 117). Hereinafter the number of shares in parentheses refers to the number after this 3 for 1 split.

3. Sources of Funds in the Trust Under the Plan.

Under the Plan, Trust funds come from the following sources:

1. Each participant is required to contribute annually one third of his compensation, defined as (a) the amount received by an employee of J. C. Penney Company under contract as a portion of the profits of the store managed by him, or (b) the amount received by a central or branch office employee as his or her share of the General Office Compensation Fund, as the case may be, exclusive of regular salary (R. 20).

2. The Company is required to contribute annually:

a. An amount equal to 2 per cent of the prior year's aggregate regular salary paid to all employees receiving compensation as defined in the Plan for all or any part of the respective year (R. 22).

b. An amount equal to 6 per cent of the Company's net profit for the prior calendar year as reflected by the books of the Company, in excess of 15 per cent of the common stock book value of the Company (R. 22).

3. Earnings of the Fund, including dividends on the Penney stock purchased by the Trustee (R. 24).

From the inception of the Plan until December 29, 1941, the amounts from these respective sources, to-

gether with their percentages of the total, were as follows (R. 137):

1. Participants' direct contribuitons	$4,041,769.28	(65.0%)
2a. 2 per cent of aggregate regular salaries contribution	102,206.97	(1.6%)
b. 6 per cent profit-sharing contribution	371,931.56	(6.0%)
3. Earnings of funds, including dividends on Penney stock purchased by Trustee	1.700.000.00	(27.4%)
Total	$6,215,907.81	(100.0%)

4. Funds Used to Repay Loan from Bank.

From the inception of the Plan until September, 1941, dividends received on the Penney stock held by the Trustee, together with the 2 per cent of aggregate of regular salaries contributions under Section 6 (a) for the year 1940 were used to cover the cost of the 50,000 (150,000) share block. Since September, 1941, dividends have been credited proportionately to participants' accounts while the 2 per cent of aggregate of regular salaries contributions under Section 6 (a) have been applied to the cost of the 150,000 (450,000) share block.

By December 29, 1941, using the funds contributed under the Plan set forth in the immediately preceding table, the loan from the bank was repaid in full.

On that date the participants had absolutely vested claims against the Trust funds totaling $4,975,668.21. To satisfy these claims, the Trustee held $389,565.61 in cash and the 200,000 shares of Penney stock.

As seen from the table on p. 8, supra, the direct contributions by participants during 1940 and 1941, during which time the loan used to purchase the stock was repaid, amounted to $4,041,769.28 or 65 per cent of the receipts of the Trustee. The indispensability of these participant contributions in enabling the Trustee to borrow the necessary money from the bank to purchase the stock may be seen from the Company's "Explanatory Reference to Proposed Plan," paragraph "5", which indicates:

> "Considering the compensation that should be paid in voluntarily by participants early in 1940 from their 1939 compensation and the dividends that would be paid to the Fund by the company on the 200,000 shares of stock during 1940, * * * it appears the collateral should be more than ample." (Exhibit 2)

> "All dividends paid on the shares and all contributions made by the participants and the J. C. Penney Company, received by the Trustees, are to be applied on the principal and interest on the loan * * *." (Exhibit 79, memorandum of June 8, 1940, for J. I. H. Herbert, signed by Walter J. Cummings)

The Company itself assumed no liability with respect to the payment of the stock loan (R. 372), nor did it

guarantee its payment, nor did it execute a hold-harmless or indemnity agreement with the Trustee or with the Bank. (R. 375).

During this time when participants' funds were completely utilized for the payment of the loan used to purchase the shares, such funds were not available for other investments for the benefit of participants. This was clearly demonstrated in the case of Mr. McAlpine who retired on August 31, 1941, at the age of 68 years. He had personally contributed $4,278.38 and had credits when leaving totaling $4,635.05 (R. 162). When he received a check for this amount, he was puzzled why there had been no earnings on his credits, as this same amount had stood to the credit of his account 9 months earlier, December 31, 1940 (Exhibit 222 C). To his request for explanation, Company replied:

> "I am indeed sorry but it appears to fall to me to give you disappointing information. The amount of the check which you received represents the full amount due you from the Fund. This results from the fact that the Fund to this point has had no monies for outside investment. In the early stages of the Plan all monies have had to be used to cover the purchase price of the 200,000 shares of J. C. Penney Company stock which was purchased by the Fund. Further, until the purchase price of the 50,000 share block is covered, all dividends received are applied to that cost. Further, the excess profit contribution by the company is an annual matter and does not apply to prior part-year participation. All this adds up to the fact that to this time no credit other than

> reflected in the check submitted is available. This is all covered in the Plan booklet, which I realize may be difficult to understand." (Letter of Trown, Exhibit 222 D)

While the loan was being repaid during 1940 and 1941, the participants bore the entire risk in the event the bank foreclosed on the stock held by the Trustee. The Company risked nothing. *Trust Agreement, Paragraph Fourth* (C), *Exhibit* 125 (R. 48):

> "* * * if any or all of the stock pledged by the Trustee is sold by the creditor, there shall be no liability on the Trustee nor on the Company nor on any member of the Administrative Committee because of any loss to participants resulting from such sale."

Pre-Trial Order, Agreed Fact 40-a, (R. 137) shows the vast discrepancy between the credits absolutely vested in and due the participants and the cash held by the Trustee. For example, on the first day of the Plan, August 1, 1940, participants contributed directly from their earnings, on which they already had paid income tax, a total of $1,575,000. That same day $1,500,000 was paid on the loan, leaving a cash balance of only $75,000 against which the participants' equity could not be satisfied were it not for the stock.

In the period from August 1, 1940, until the stock loan was fully repaid on December 29, 1941, the cash

balance dropped as low as $13,360.41 (March 26, 1941), yet on that date participants had vested and absolute interests in receiving $4,396,578.52 had they chosen voluntarily to withdraw, or if the Plan had failed for any other reason. During this period, the cash held by the Trustee seldom exceeded $100,000. The only asset, therefore, which could satisfy the demands of all participants, had the Plan been terminated during this period, was the Trustee's equity in the stock, which equity did not become an unencumbered asset of the Trust until the loan was repaid on December 29, 1941.

5. Benefits Under the Plan Other Than Stock.

Each participant, regardless of the manner of separation from the Company, whether death, discharge, withdrawal or retirement under the Plan, was entitled to receive an annuity or cash consisting of the following amounts:

1. Total of his contributions.

2. A proportionate share of the 6 per cent profit-sharing contributions.

3. A proportionate share of the earnings of the Trust, including, commencing in September, 1951, dividends on the Penney stock held by the Trustee. (R. 28-32).

6. Stock Benefits.

In addition to the benefits received by all participants regardless of when or how they leave the Company, those participants who live to age 60 while still in the employ of the Company receive a number of shares of said Penney stock:

> "without cost, from the 50,000 (150,000) share block of J. C. Penney Company common stock, that number of shares * * * represented by the proportion of 150,000 (450,000) shares that the participant's total contributions at the time of his or her retirement bear to the aggregate of such contributions of all participants in the Fund at such time * * *
>
> "When the 50,000 (150,000) share block of stock is exhausted, distribution on retirement shall be from the 150,000 (450,000) share block, based on the proportion of the remaining shares that the retiring participant's total contributions at the time of his or her retirement bear to the aggregate contributions of all participants at such time." (R. 29).

The 50,000 (150,000) share block was, projecting previous experience, exhausted in 1955. Stock awards from that time on therefore become less and less regardless of the fact that a participant's ratio under the formula is the same or higher than those retiring prior to 1955.

Although the Penney officials had "studied Plan after Plan," the stock feature was unique, not found in any other Plan (Hughes, R. 360, 370). It will be shown in detail in this brief, infra pp 20-7, how use of the

formula for awarding stock produces increased stock benefits to participants by virtue of the predecease, discharge or withdrawal of fellow participants.

7. Present Action Attacks Plan Only as it Relates to Stock.

On July 11, 1951, appellant Harvey L. Wells, the former manager of the Corvallis, Oregon, store of appellee J. C. Penney Company, and appellant Harry J. Albertsen, the former manager of East Los Angeles Store No. 925 of appellee J. C. Penney Company, instituted this action on behalf of themselves and all *former* participants (their beneficiaries, heirs and legal representatives) who died or otherwise failed to reach retirement status under the Plan but whose contributions and earnings were used by the Trustee to purchase shares of J. C. Penney stock for the Trust.

This action seeks to adjudge (1) that the Plan, in so far as it relates to these shares of Penney stock, constitutes a wagering scheme, lottery or tontine contract in violation of New York law and public policy and (2) that the Trust as to said shares is illegal, void and of no effect. Appellants ask that said shares of Penney stock be held in a resulting trust for the benefit of appellants and other participants, former and present, in proportion as their contributions and earnings were used for the purchase of such stock.

8. Applicability of New York Law.

The Plan and Trust are to be construed in accordance with the laws of the State of New York (R. 178).

QUESTIONS PRESENTED

1. Is the method for awarding stock as set forth in the Plan and Trust Agreement illegal and void because participants benefit from the predecease, discharge and withdrawal of fellow participants in whom they have no insurable interest?

2. Does the method for awarding stock as set forth in the Plan and Trust Agreement violate New York Constitutional and statutory prohibitions against lotteries and wagering contracts?

3. If the method for awarding stock is illegal and void, does the trustee hold the stock upon a resulting trust for those whose contributions and earnings were used to purchase the stock?

SPECIFICATIONS OF ERROR

1. The District Court erred in failing to find that the Plan and the Agreement of Trust provide benefits contingent on the predecease, discharge and withdrawal of participants.

2. The District Court erred in finding that the Plan was not unfair, discriminatory or illegal because older

employees, among them some members of Company's Board of Directors, who were among the first to qualify for retirement with stock, received a greater number of shares than younger and future employees will receive when they retire. This error is contained in the District Court's Finding of Fact No. 46 (R. 244) and Conclusion of Law No. 13 (R. 251).

3. The District Court erred in finding that the Plan, so far as it pertains to the shares of capital stock of Company, is not a wagering contract, lottery or tontine contract and does not violate the New York Constitution, statutes, laws and public policy prohibiting such contracts and schemes. This error is contained in the District Court's Findings of Fact No. 47 and 48 (R. 245) and Conclusions of Law No. 5, 6, 7, 8 and 10. (R. 250-1)

4. The District Court erred in admitting in evidence, over the objections of appellants, the testimony of Albert W. Hughes consisting of extrinsic evidence concerning the meaning of the Retirement Plan and Trust. Said testimony is contained in the transcript of proceedings (R. 360-367). On direct examination, counsel for appellees asked A. W. Hughes, President of Company "the reason why there was included in the profit-sharing retirement plan the provisions for stock being issued to participants who left on the retirement age" (R. 355). Objection was made by Mr. King, counsel for appellants, on the following grounds:

"If the Court please, I object to that as the plan is on exhibit in this case, Exhibit 125, and it is written. I do not think it is proper. There has been no issue raised in the contentions as to the understandings of it, and I think the plan is here, and, therefore, it improperly calls for evidence tending to vary the plan as adopted.

* * *

"* * * And that it is improper for this witness to attempt to vary the terms of the plan by oral testimony.

* * *

"* * * the contention was never included in this pre-trial order and it takes us by surprise here that they are making that contention. There was never anything advanced in the pre-trial order along this line, nothing in the contentions of law nor in the contentions of fact, and I understood that when you made and prepared a pre-trial order, that plaintiffs were entitled to rely on it. Now they come in here with a new contention that we do not know anything about, * * *.

* * *

"* * * that it is immaterial under any issues of fact or law in the present action, * * *

"* * * And may the objection go to the whole line without repeating the objection?

"THE COURT: Yes." (R. 355-359)

The testimony admitted over these objections was to the effect that the stock award provisions were included in the Plan because of "sound business judgment" (R. 357) "done in good faith for a valid business purpose" (R. 357).

5. The District Court erred in failing to find that the Trust purported to be established under the Plan, so far as it pertains to the shares of capital stock of Company, was and is illegal and void and of no effect and in failing to adjudge and decree that the Trustee holds the shares of stock of Company under a resulting trust in favor of appellants and those for whom appellants prosecute this action. This error is contained in the District Court's Conclusions of Law No. 16, 17, 18, 20 and 21 (R. 252-4).

6. The District Court erred in determining that the stock portion of the Retirement Plan is unseverable from the remaining portions of the Plan. This error is contained in the District Court's Findings of Fact No. 43 and 44 (R. 243) and Conclusion of Law No. 9 (R. 251)

7. The District Court erred in finding that it would be highly inequitable to permit appellants to recover in this proceeding on their own behalf and on behalf of the class for which they are suing. This error is contained in the District Court's Finding of Fact No. 58 (R. 249) and Conclusion of Law No. 19. (R. 253)

8. The District Court erred in failing to award appellants compensation for the reasonable value of the services of their attorneys in the prosecution of this action and for their costs and disbursements incurred herein, and in failing to decree that the sum so awarded should constitute a lien upon the shares of stock found

by the court to have been acquired by the contributions and earnings of appellants and those for whom they prosecuted this action.

SUMMARY OF ARGUMENT

I. THE PROVISION OF THE PLAN AND TRUST AGREEMENT FOR THE AWARD OF STOCK IS ILLEGAL AND VOID.

A. The Award of Stock is Contingent on the Lives and Continued Employment of Participants Contrary to New York law and Public Policy.

1. The stock scheme is a tontine contract involving wagers on the lives of fellow participants in violation of New York law.

2. The method for awarding the stock purchased with the contributions and earnings of participants violates New York constitutional and statutory prohibitions against wagering contracts and lotteries.

B. The Nature of the Scheme for Awarding Stock, not the Alleged Good Intentions of the Sponsors, Determines Whether or not it Constitutes a Tontine Contract, Wagering Contract or Lottery.

II. THE TRUSTEE HOLDS THE SHARES OF STOCK UNDER A RESULTING TRUST FOR THOSE WHOSE CONTRIBUTIONS AND EARNINGS WERE USED IN THEIR PURCHASE.

A. The Assets of a Trust, or any Part Thereof, Which is Illegal and Void, are Held in a Resulting Trust for Those who Contributed to the Trust.

B. The Stock was Purchased With the Contributions and Earnings of Those Persons who were Participants in the Plan During 1940 and 1941.

ARGUMENT

I. THE PROVISION OF THE PLAN AND TRUST AGREEMENT FOR THE AWARD OF THE STOCK IS ILLEGAL AND VOID.

A. *The Award of Stock is Contingent on the Lives and Continued Employment of Participants Contrary to New York law and Public Policy.*

The District Court failed and refused to find as a fact that the Plan and Agreement of Trust provide benefits contingent on the predecease, discharge and withdrawal of participants. On the other hand, the District Court did not make any finding to the contrary. The failure of the court below to make any finding on this issue is the subject of Appellants' Specification of Error 1.

Calculation of Stock Benefits. As set forth previously supra, p. 13, the amount of stock awarded each retiring participant is determined by a ratio which that participant's credits bear to the credits of all participants when applied to the larger block of 150,000 (450,000) shares. The larger block was to remain intact until the smaller block of 50,000 (150,000) shares was exhausted, after which time awards are made directly from the larger block. Thus, those retiring while there are shares still remaining in the smaller block have their ratio measured against the undiminished 150,000 (450,000) share block. Once the smaller block is depleted, how-

ever, each participant's ratio is applied to whatever stock remains in the larger block, which block decreases each year to the extent that stock is awarded to retiring participants. In 1953 there were only 11,251 (33,754) shares remaining out of the smaller block. (R. 138) Projecting the retirement experiences of 1951, 1952 and 1953, this smaller block was exhausted in July, 1955. All subsequent awards of stock therefore will be measured against the ever diminishing larger block.

The number of shares awarded a retiring participant is determined by a formula consisting of two factors, a multiplier (a fraction of which the numerator is the participant's total contributions to date and the denominator is the aggregate of the "contributions of all participants in the Fund *at such time*") *and a multiplicand* (the number of shares at that moment remaining in the 150,000 (450,000) share block):

Multiplier — Multiplicand

$$\frac{\textit{Participant's Contributions}}{\text{Contributions of all participants in Plan at the moment}} \times \text{150,000 (450,000) or as much as is remaining in the larger block of shares at the time} = \text{Number of shares awarded}$$

Effect of Death, Discharge or Withdrawal. The death, discharge or voluntary withdrawal of any participant benefits the remaining participants in two ways:

(1) A participant benefits by the predecease, discharge or withdrawal of any participant who is the same age as he or younger than he. This is due to the effect upon the multiplier by which his stock award is determined upon retirement. The denominator of the fraction is decreased by the predecease, discharge or withdrawal of the participants who are the same age or younger. Consequently, the multiplier and thus the number of shares awarded the retiring participant is increased.

(2) Moreover, a participant benefits from the predecease, discharge or voluntary withdrawal of any older participant. The predecease, discharge or withdrawal of the older participant increases the number of shares awarded to his surviving younger participants by delaying the extent to which and the time at which the 150,000 (450,000) share block of stock by which the awards are measured is reduced. Deaths, discharges and withdrawals of participants prior to the exhaustion of the 50,000 (150,000) share block served to postpone until 1955 the time when invasion of the 150,000 (450,000) share block commenced. Of the 943 participants who left the Plan by reason of death, discharge

or withdrawal up to 1953, a large number would have retired prior to 1955. Now that the 150,000 (450,000) share block diminishes annually with each award of stock, such deaths, discharges and withdrawals slow the rate of depletion of the stock held by the Trustee.

Examples will illustrate the significant increases in stock awards made to surviving participants by reason of the predecease, discharge and withdrawal of fellow participants. Fifty men retired with stock awards in 1945. Seventeen members of the class of 1945 (who for purposes of retirement under the Plan were the same age as the 50) did not "graduate" (retire with stock awards), 6 of them because of death: B. G. Huse, F. M. Beamer, Chas. Ehler, H. L. Hoagland, M. B. Warner and G. C. Taylor (R. 162). These six men died between May, 1943, and February, 1945, and their actual contributions up to the date of their respective deaths totaled $120,393.94.

When Mr. Herbert (Third Vice-President and Treasurer of Company, R. 99) retired in 1945, he received 830 (2,490) shares of stock. This number was arrived at by ascertaining Mr. Herbert's ratio of contributions to the aggregate of contributions and applying that ratio to the 150,000 (450,000) share block:

$$\frac{\$\quad 86{,}133.73}{15{,}563{,}428.63}\quad \begin{matrix}\text{(Exhibit 67)}\\ \text{(R. 140)}\end{matrix}$$

This ratio equaled .0055343 (Exhibit 67). When applied to 150,000 (450,000) shares, this ratio indicated 830 (2,490) shares due Mr. Herbert.

Had the 6 men named above not died, the denominator would have been increased by at least $120,393.94, the total amount contributed by these 6 up to their respective deaths. Mr. Herbert's ratio, therefore, would have been calculated as follows:

$$\frac{\$\quad 86,133.73}{15,683,822.57} = .0054929$$

Applying this ratio to 150,000 (450,000) shares, Mr. Herbert would have received only 824 (2,472) shares. (Had these 6 men not died, their contributions from their dates of death until July, 1945, would have continued and increased the denominator even more than $120,393.94, proportionately *decreasing* Mr. Herbert's stock award.) Disregarding that, however, it is certain that Mr. Herbert received 6 (18) of his shares directly because of the death of these 6 men.

The deaths of these 6 men benefited not only Mr. Herbert but also increased the *ratios* and therefore the numbers of shares received by each of the other of the 50 men retiring in 1945; for these 6 were the same age as the 50, at least for purposes of retirement. Such deaths also benefited the dividend accounts of these 50, to the extent that their increased ratios entitled

them to more dividends prior to retirement than otherwise would have been the case (R. 24, 28, 30).

The decease of these 6 before retirement also benefited younger participants by slowing the depletion of the stock corpus. These 6 men in the aggregate would have been entitled to *at least* 1,152 (3,456) shares, had they lived until 1945, on the basis of contributions already made up to their deaths. (Had they not died, of course, their aggregate numerator would have been proportionately larger):

$$\frac{\$ \quad 120{,}393.94}{15{,}683{,}822.57} = .007679$$

$$.007679 \times 150{,}000\ (450{,}000) = 1{,}152\ (3{,}456)$$

By failing to live until retirement, these 6 men, who would have consumed 1,152 (3,456) shares, over 2 per cent of the 50,000 (150,000) share block, had they lived, delayed the time when the multiplicand—the 150,000 (450,000) share block—would commence to be diminished. When the startling effect of the deaths of these 6 men is analyzed and it is remembered that up to 1953, 943 men have withdrawn from the Company, 102 of whom because of death (R. 167), the increased awards to surviving participants are obviously substantial.

Another illustration graphically demonstrates how a participant's stock award increases significantly by

the predecease of fellow participants. Mr. Binzen (Executive Vice President, R. 102) and Mr. Hughes (President, R. 102) made identical contributions to the Plan from its inception until Mr. Binzen's retirement in 1950. Mr. Hughes, a year younger than Mr. Binzen, did not reach retirement age until 1951. If Mr. Hughes had died the first part of 1950, this *necessarily* would have increased Mr. Binzen's stock benefits, illustrated as follows:

Personal contributions in the Fund on July 1, 1950, were $25,559,056.54 (R. 140), including Mr. Binzen's and Mr. Hughes' contributions for the eleven years, 1939 through 1949, of $157,867.08 each (R. 150). Because Mr. Hughes was living when Mr. Binzen retired with stock in July, 1950, Mr. Binzen's stock benefits were determined as follows:

$$\frac{\$\quad 157{,}867.08}{25{,}559{,}056.54} = .0061766$$

$$.0061766 \text{ X } (450{,}000) = (2{,}779) \text{ shares}$$

Had Mr. Hughes died in early 1950, the denominator of the above ratio would have been reduced to the extent of Mr. Hughes' contributions of $157,867.08, leaving a balance of $25,401,189.46. Mr. Binzen's stock benefits would have been determined as follows:

$$\frac{\$\quad 157{,}867.08}{25{,}401{,}189.46} = .006215$$

$$.006215 \text{ X } (450{,}000) = (2{,}797)$$

Thus, had Mr. Hughes predeceased Mr. Binzen, the latter would have gained (18) shares from his death alone!

Participation by Executive Group. Such substantial increases in stock awards resulted not only from the premature deaths of participants but also from discharges and withdrawals of participants prior to age 60. This is important in view of the fact that no participant in the Plan had any right to continued employment with the Company. Any participant could be discharged without cause and thereby be deprived of his eligibility for retirement with stock (R. 177, 178). Since the Plan has been in operation, the groups of men with the power and opportunity to discharge any participant in the Plan, or influence such discharge, were composed predominantly of persons who were themselves participants and who stood to gain from the discharge of other participants prior to their reaching retirement status. From 1939 until 1951, all the positions on the various governing groups of the Company and Plan were filled by 19 men, of whom 14 were participants in the Plan (R. 98-105, 150). At the end of 1951, except for Mr. Trown (Comptroller R. 104), who left the Company voluntarily, 6 of these 14 had retired with stock and 7 were still participants in the Plan.

Not only did these men at all times possess unlimited and arbitrary power over the employment of every

participant, but they had power to permit optional retirements to persons in certain age groups (R. 25-26). No such early retirements with stock were permitted, thereby retaining in the Trust shares which might have gone to those eligible if permission had been granted. Seven participants set the determined policy of no early retirements with stock, 5 of which 7 themselves retired with stock between 1945 and 1951; Herbert, Ross Reynolds, Binzen and Hughes (R. 151, 153, 157, 150).

This power to cut down stock awards either by discharging participants before age 60 or by refusing all requests for optional retirement at earlier ages is important *not because such power may have been improperly exercised* but because it placed such persons in a position in which their duties to participants conflicted with their self-interest or with their interest in the Company. In order to appreciate the magnitude of this conflict of interest, it must be realized that these men who held this power stood to benefit on the average from 6 to 8 times as much as other participants from the predecease, discharge or withdrawal of participants. Four exhibits confirm this fact:

(1) Exhibit 67 shows that on July 1, 1945, 50 men retired, including Mr. Herbert and Mr. Ross. The other 48 retired with an average stock allocation of *(345)* shares each (allowing for the 3 for 1 split). However,

Mr. Herbert and Mr. Ross took *(2,490)* and *(2,409)* shares respectively, approximately 7 times the average of the other participants, and about *(900)* shares more than the highest participant other than themselves.

(2) Exhibit 69 shows that on July 1, 1947, 16 men retired, including Mr. Reynolds. The other 15 retired with an average stock allocation of *(430)* shares each. However, Mr. Reynolds took *(2,717)* shares, over 16 times the average of the other participants, and almost *(1,000)* shares more than the highest participant other than himself.

(3) Exhibit 72 shows that on July 1, 1950, 30 men retired, including Mr. Binzen. The other 29 retired with an average stock allocation of *(338)* shares each. However, Mr. Binzen took *(2,779)* shares, over 8 times the average of the other participants, and two and a half times or *(1,669)* shares more than the highest participant other than himself.

(4) Exhibit 73 shows that on July 1, 1951, 35 men retired, including Mr. Hughes. The other 34 retired with an average stock allocation of *(365)* shares each. However, Mr. Hughes took *(2,755)* shares, over seven and a half times the average of the other participants and about *(900)* shares more than the highest participant other than himself.

These 5 men, who together constituted but .17 per cent of the 2,906 participants in the Plan during 1940-

1951, have already personally received 2.2 per cent of *all* the Penney stock purchased by the Trustee. As the above exhibits showed, the predecease, discharge and withdrawal of participants prior to the retirements of these men increased their stock awards in this same disproportion.

The stock was bought with a loan paid off by the contributions and earnings of participants during the first two years, 1940-1941. Amounts of stock awarded depend not only on the survival of the retiring participants to age 60 while remaining in the employ of the Company but also upon the predecease, discharge or withdrawal of fellow participants. The more fellow participants who die, are discharged or withdraw from the Company before age 60, the greater the stock awards to their survivors. The inequity involved in awarding to surviving participants greater amounts of shares was recognized by the federal court in New York in considering a bonus plan.

Winkelman v. General Motors Corp. (S.D. N.Y., 1942) 44 F. Supp. 960, 1005

In 1917, with the approval of its stockholders, General Motors Corporation adopted a bonus plan whereby an executive was awarded as his bonus for a certain year a number of shares of stock, one fourth of which

was immediately delivered to him, and one fourth during each of the three succeeding years, with the provision that if such executive left the employ of the company he forefeited any undelivered stock and the same reverted to the corporation. The directors amended the plan so that the forfeited stock reverted to the Bonus Fund and was reawarded to the other participants. In holding in the present stockholders' suit that the directors were liable for the value of such stock the court stated on page 1005:

> "* * * to bring into the bonus fund in which directors participated great blocks of forfeited stock, did not meet the standards set for these fiduciaries in the exercise of their power of amendment.
>
> * * *
>
> "A large part of the reawarded forfeited bonus stock had been part of a bonus award made several years prior thereto. The men who originally received the award were given their share of the 10% net earnings which they had helped to create. Those who received the forfeited bonus stock, when it was later reawarded, either had nothing to do with the creation of the earnings in the year for which the bonus stock had been awarded, or if they did contribute to those earnings they had received their proper share thereof in the bonus awarded to them for that year. There does not appear to be any equitable basis for this amendment of the bonus plan."

Here, the method of awarding Penney stock to surviving participants similarly has no relation to the earn-

ings of the retiring participants. It is this method that is condemned by New York law and public policy.

1. The stock scheme is a tontine contract involving wagers on the lives of fellow participants in violation of New York law.

Specification of Error 2 concerns the lower court's finding and conclusion that the gradual diminution of stock benefits for participants retiring after 1955 is sound. Specification of Error 3 attacks the District Court's findings and conclusions that the Plan for awarding stock is not a wagering contract, lottery or tontine contract and does not violate the New York constitution, statutes, laws and public policies prohibiting such contracts and schemes. The determination of the legality of the provisions in the Plan and Trust Agreement for the awarding of stock is a question of law regardless of whether the District Court's determinations in that regard are denominated findings of fact or conclusions of law.

Prohibitions against wagers on the lives of others are of long established precedent in New York.

Ruse v. Mutual Ben. Life Ins. Co. (1861) 23 N.Y. 516, motion for reargument denied (1862) 24 N.Y. 653

Only where there exists an "insurable interest," as defined by law, are retirement benefits contingent on the lives of others permitted.

New York Insurance Law, Section 146.

> "1. * * * no person shall procure or cause to be procured, directly or by assignment or otherwise any contract of insurance upon the person of another unless the benefits under such contract are payable to the person insured or his personal representatives, or to a person having, at the time when such contract is made, an insurable interest in the person insured. * * *
>
> "2. The term, 'insurable interest', as used in this section, shall mean: (a) in the case of persons related closely by blood or by law, a substantial interest engendered by love and affection; and (b) in the case of other persons, a lawful and substantial economic interest in having the life, health or bodily safety of the person insured continue, as distinguished from an interest which would arise only by or would be enhanced in value by, the death, disablement or injury, as the case may be, of the person insured."

New York Insurance Law, Section 200 (5)

> "Such * * * [retirement system] contract shall conform to the provisions of this section and, in so far as practicable, to the other provisions of this chapter applicable to similar policies or contracts."

Where persons stand to benefit from the predecease of others in whom they have no insurable interest, the laws and public policy of New York are violated. For this reason schemes which provide for accumulations to be awarded survivors of a group are illegal and void

in many states, including New York. Such accumulations to be awarded survivors are known as "tontines." Tontine accumulations have an effect completely opposite from that of regular life insurance. Regular life insurance is designed to compensate persons for the loss or casualty of one in whom they have an insurable interest. Tontine benefits, on the other hand, do not accrue to compensate those who suffer any loss from the death of another. Instead they provide a windfall prize to someone lucky enough to survive other persons whose deaths have no adverse effects on the survivor. Indeed, the fortunate survivor benefits, while losing nothing, from such deaths.

Walker v. Walbridge (1934) 151 Misc. 329, 271 N.Y.S. 473

Defendant subscribed to a contract furnished by a life insurance agent whereby not more than 100 persons bound themselves to take out life insurance on their own lives, all designating the same trust company as beneficiary-trustee of the policies. By the terms of the contract each policyholder agreed to maintain his insurance in force for at least five years. If, during that period, a policyholder should die, under the contract 25 per cent of the face amount of the policy was to be distributed by the trustee to the surviving policyholders according to the proportion which their first-

year premiums bore to total first-year premiums. The remaining 75 per cent of the face amount was to be distributed to beneficiaries designated by the policyholder. The contract was to expire after five years.

As part of the consideration due by the terms of the contract, defendant made a note payable to C. W. Colgrove System, Inc., the predecessor in interest of the plaintiff. In an action brought on the note, plaintiff moved for judgment on the pleadings. In denying plaintiff's motion and dismissing the complaint, the court stated on pages 480 to 482:

> "By his defenses the defendant claims that the contract was at the time of its execution and delivery and now is a wagering contract, and therefore the note on which suit is brought is illegal and void as being given in violation of public policy. The purported indebtedness covered by such note and described in the contract was a premium of insurance on the life of the defendant herein which insurance was issued by the Union Central Life Insurance Company in the amount of $100,000. The contract has been passed on by the Supreme Court of the State of Illinois. Colgrove v. Lowe, 343 Ill. 360, 175 N.E. 569. That learned court held that a similar agreement was null and void because it was a wagering contract and contrary to public policy of that state. The Supreme Court of Illinois did not pass on the validity of the insurance issued in connection with such contract nor on the enforceability of indebtedness for the premium of such insurance. In order to dispose of these motions, it is necessary that this court pass on the legality of the insurance, the contract, and the note.

"The principal ground on which the transaction, of which the insurance policy, the contract, and the note were a part, is attacked as a gambling transaction is that the ninety-nine persons who are named as possible beneficiaries of the policy have no insurable interest in the life of the defendant herein and the insured named in such policy and contract. It is well-settled law that, if the beneficiary named in a policy has no insurable interest in the life of the person insured, then the transaction is a wagering one and void as against public policy, unless the insured has selected such beneficiary. Reed v. Provident Sav. Life Assurance Society et al., 190 N. Y. 111, 82 N. E. 734. * * * In the case at bar, the beneficiaries are not selected by the insured, but may be any ninety-nine other persons who desire to gamble on the length of the lives of themselves and their associates, including the defendant herein. Thus we have a case where any one of these ninety-nine persons, evilly minded, would have an incentive to shorten the life or lives of some or all others of the one hundred insured so that the person so inclined could benefit under the one hundred policies. It is in view of situations akin to this that the courts have declared it against public policy to insure the life of a person for the benefit of some one who has no insurable interest and who is not selected by the insured with caution for his own safety. * * *

"Applying these tests as to what is insurable interest, this court comes to the conclusion that the other ninety-nine persons of the one hundred persons referred to in the contract and made the beneficiaries of the policy have no insurable interest in the life of defendant herein and he has no insurable interest in their lives, and therefore the transaction which included such policy and contract is void as being part of a wagering contract and against public policy."

Colgrove v. Lowe (1931) 343 Ill. 360, 175 N.E. 569, certiorari denied (1931) 284 U.S. 639, 76 L. Ed. 544

In this case, cited with approval by the New York court, complainants filed a bill to restrain Lowe and others from revoking Colgrove's license to act as an insurance agent and from interfering with the "Colgrove" system used in the sale of life insurance policies. (This system is set forth in *Walker v. Walbridge*, supra, p. 34). In affirming the dismissal of the bill on the ground that the contract was void as against public policy, the court stated on pages 571 and 572:

> "The inducement or consideration held out to the applicant for life insurance by this method is the chance to profit, if he lives, by the early death of one or more of the other ninety-nine contracting parties, in whose lives he cannot possibly have any insurable interest. A direct financial gain is anticipated by the application of part of the insurance carried by the members who die to help reduce the premiums on the insurance carried by those who live. The applicant thus expresses his willingness to forfeit 25 per cent of the insurance money which would otherwise be paid to his own beneficiaries if he died during the first five years, for what he thinks is a better chance to live during this five-year period and participate in some of the death dividends of his contemporaries. This is nothing but speculation in human life and as such the contract is void as a wagering contract. The very basis of the scheme is a wager for personal profit—an opportunity to speculate on one's chances of outliving the other members. The trust fund created by the death of any of the contracting parties is a sum of

money of which the trust company is the stakeholder, under an agreement to divide the sum among the winners, who are to be determined by the chances of life. The different contracting parties have no insurable interest in the lives of one another, and to allow them to benefit by the death of others of their number is to allow them to do indirectly by a contract what they are not allowed to do directly. * * *

"The contract under consideration is a wager upon the lives of others in whom the parties to be benefited have no insurable interest, and the use of such a contract to promote the sale of life insurance presents an appeal to the gambling instincts of prospective policyholders that is contrary to sound principles of public policy."

Benefits contingent on the lives of others, declared the court, have long been condemned.

(pp. 571-572)

"Mr. Justice Holmes in the case of Grigsby v. Russell, 22 U. S. 149, 32 S. Ct. 58, 56 L. Ed. 133, 36 L. R. A. (N. S.) 642, Ann. Cas. 1913B, 863, said: 'The very meaning of an insurable interest is an interest in having the life continue. * * * Indeed, the ground of the objection to life insurance without interest in the earlier English cases was not the temptation to murder, but the fact that such wagers came to be regarded as a mischievous kind of gaming.' * * *

"* * * the language in the case first cited, as above quoted [Warnock v. Davis, 104 U.S. 775, 26 L. Ed. 924], remains unchallenged in its general definitions of pecuniary interest and wagering contracts and is especially applicable to the contract we are now considering. Referring again to the language in Grigsby v. Russell, supra, it correctly

expresses our view that the principal objection to the contract used in the Colgrove system is not so much that it offers a temptation to commit crime as that it is an inducement to speculate and gamble in human life, in which the participants occupy a position directly opposite to that of life insurance companies, all of which are primarily interested in the continued life of each policyholder."

Knott v. State (1939) 136 Fla 184, 186 So. 788, 121 A.L.R. 715

Knott, the State Treasurer, issued to the realtor a certificate authorizing it to do business in Florida but prohibiting it from issuing a certain policy containing tontine benefits. Realtor unsuccessfully sought a writ of mandamus to compel Knott to delete said prohibition from the certificate. The court held that the prohibited contract constituted a wagering scheme and, as such, was void as against public policy.

The prohibited contract provided for paying each insured $1,000 at age 70 or the same amount to insured's named beneficiary if the insured died earlier. In addition, insured was to receive upon the death of each policyholder of his age who was insured in the same year a portion of the face value of such policy according to the ratio which the face value of insured's policy bore to the total of all policies in his class.

In this case the class consisted of those in a particular age group. Similarly, in the Penney Plan, each class

consists of those who reach age 60 in the same year. The Penney scheme differs, however, in that the deaths of all participants, whether or not in the same "class' and regardless of when they join the Plan, benefit their survivors. The evil in the Penney scheme is more widespread; for tontine benefits are not restricted to a single age group. Nevertheless, the contract involved in the Knott case was illegal. (pp. 789-790)

> "* * * if all policy holders in the same class except one should die before reaching the age of seventy years the sole survivor would have received his proportionate share on each death and the beneficiary of the first to die would have received only the first allotment.
>
> "We have examined the case discussed by counsel for the respective parties, Colgrove v. Lowe, 343 Ill. 360, 175 N. E. 569, and do not find where the policy there declared to be against public policy differs in principle from the one we are considering. * * *
>
> "Clearly, the holder of one of the policies of defendant in error would profit by the death of another in his class as did a contract holder under the Colgrove system, and it is plain, too, that here, as there, the one policy holder in the same group has no more interest in the continuance of the life of the others. * * *
>
> "We think a wagering contract is against the public policy of the State of Florida * * * .
>
> "* * * the 'Special Endowment Benefit' is a wagering contract, hence contrary to public policy in this State, * * * "

Fuller v. Metropolitan Life Ins. Co. (1898) 70 Conn. 647, 41 Atl. 4, 10, 15

In this suit the assignees of surviving policyholders claimed that defendant company had not given them the full amount of surpluses under their contracts. Each policy provided for a reserve dividend account which accumulated during the 10 year period from five sources: (1) ordinary dividends on existing policies, (2) accumulated dividend bequeathed to the class from dying participants, (3) accumulated dividends forfeited to the class by retiring participants, (4) reserves from all lapsing policies, and (5) compound interest on these forfeited funds.

Both the majority and concurring opinions agreed that the judgment should be set aside because of error in admitting the testimony of officials of defendant as to the meaning of the contract. Just as in the case of the Penney Plan, "The meaning and legal effect of the policy and of the document claimed as referred to by the policy was a question of law for the court" (41 Atl. at p. 15).

And, as to this question, the court indicated clearly the illegality of tontine contracts.

> "Life insurance is protection given to one person against the damage he may suffer through the

death of another. A mere wager on the accident of death is void.

* * *

"All that distinguishes ordinary life insurance from a wagering contract is the theory of protection against damage that may be suffered through another's death. This protection may be purchased by the insured in behalf of his own family, or of those he sees fit to make his beneficiaries. It may be purchased by one on his own account, where he may suffer damage from another's death by reason of kinship, the relation of creditor, or other insurable interest. But when this element of protection is entirely eliminated, the insurance is a wager, and the contract is void. Cronin v. Insurance Co. (R. I.) 40 Atl. 497. In the present case the policy holders stipulate between themselves that the surrender value of each policy lapsing, which represents payments made in behalf of the beneficiary, shall go to benefit other policy holders living a certain time, who are total strangers to the policy and the insured. This is a mutual wager upon the chances of life. There is no conceivable element of protection. The sole purpose of the bet is personal profit. It is the risk of what is due to each in the case of a lapse for the chance of winning what is due to others. It is correctly described by the plaintiffs' counsel as 'the chance to speculate on his chances of surviving the other members.' On this ground these policies were urged upon the public, by appeals to the gambling instinct, claiming, as stated in the Stewart pamphlet, that 'risk is the condition of success.' The only way to evading the invalidity of such a contract is by the claim that the policy holders in fact wager nothing; that all payments of premiums belong to the company, including those applied to maintain a reserve; and the policy holders are not entitled to any particular sum, but only

> to an equitable proportion of the excess of assets over liabilities at the time of dividend. We do not pass upon the sufficiency of this claim. But, if the claim of the plaintiffs be true; if upon each lapse a sum equal in amount to the reserve value of the policy lapsing becomes a liability of the company, which it must pay to the surviving policy holders, —then all doubt as to the gaming nature of the transaction vanishes. The pool thus created is composed of definite sums of money of which the company is stakeholder under an agreement to divide these sums among the winners, who are to be determined by the chances of life."

The concurring judges dissented from the "construction given" to the contract by the majority and felt that the appellate court should have granted plaintiffs a new trial. The majority, however, set aside the judgment without granting a new trial indicating that, because of the illegality of the contract, "If, therefore, the plaintiffs could maintain their claim, the result would be the dismissal of their complaint" (41 Atl. at p. 15).

United States Life Ins. Co. v. Spinks (1906) 29 Ky.L. 960, 96 S.W. 889, petition for rehearing overruled (1907) 126 Ky. 405, 103 S.W. 335, appeal dismissed (1908) 209 US 539, 52 L. Ed 917.

This case involved the legality under New York law of tontine accumulations, or "dividend additions." In order to prevent forfeitures of the cash or reserve value of a life insurance policy upon failure of a policyholder to pay a premium, New York law has for many years

required the application of such reserve values to the purchase of paid up insurance, commencing from the time the policyholder fails in his obligations. In this case, the question was whether the defendant company was required, as to Mr. Spinks, to apply not only his "reserve" but his equitable share of the tontine accumulations. If so, the policy would have been in effect at his death, and the beneficiary, the insured's son, could recover thereunder. If not, the policy would have lapsed from nonpayment.

The lower court awarded plaintiff recovery under the "extended" policy, and the judgment was affirmed. Because the company was a mutual company, the court concluded the tontine surplus "should in equity go to those who had contributed it" (96 S.W. at p. 894). In so applying the proportionate share of the tontine accumulations "to those who had contributed," the court explained why distribution under the contract was improper.

> "The original tontine contemplated that the total fund should go to the survivors of a class, regardless of the cause of their dropping out. When applied to insurance it seems to have an opposite effect from the real matter of insurance, the latter being to pay you if you die, the former to pay you if you do not. Tontine insurance, therefore, was an agreement to divide the 'surplus' which all of that class had contributed, among those who outlived the term agreed upon, and who persisted as paying members." (96 S.W. at p. 894)

In overruling the Company's petition for rehearing, the court looked beyond the technical meaning of terms to the inequities involved in tontine accumulations. The fact that tontines were, in this country, originated by Equitable of New York and adopted by New York Life and other leading companies did not save them from invalidity.

> "But there was in 1879 and 1880, and had been for a decade or more previous, a crying evil in life insurance, which had aroused widespread bitter feeling, and had brought the management of insurance companies under severe criticism; and that was the unjust, unconscientious, inequitable practice of forfeiting the reserve, as well as accumulations of 'tontines' in event of a failure of the insured to pay each recurring premium. The bubble that had grown to the most noticeable proportions was that of the 'tontine' feature, a pure hazard. But many companies issued 'semitontine,' 'free tontine,' and other policies partaking more or less of the character of the pure tontine, which, as has already been pointed out, was not insurance at all, strictly speaking. Among those mentioned was 'deferred dividend' policies. They were, if you died before the period arrived for declaring the 'dividend' out of the 'surplus,' you got no part of the 'surplus' —that went to those who survived the 'period of distribution' * * *." (103 S.W. at p. 336)

The Penney Plan contains all the improper features of the tontine insurance schemes held invalid in all the above discussed cases. In addition to the impropriety of benefits accruing from the predecease of fellow par-

ticipants, the Penney Plan also permits increased benefits to accrue because of discharges and withdrawals of other participants. The motivation to benefit from the discharge or withdrawal from employment of fellow participants before age 60 is as contrary to public policy as the motivation to benefit from the predecease of another. The evil of the Penney Plan inheres in the *possibility* of such benefits accruing, not in any charge or proof that any improper conduct in this regard took place.

2. *The method for awarding the stock purchased with the contributions and earnings of participants violates New York constitutional and statutory prohibitions against wagering contracts and lotteries.*

The invalidity of the Penney Plan as a tontine contract just discussed arises from the application of the general policy against wagering schemes and lotteries as applied to the specific case of benefits contingent on the lives of others. A fortiori, the Plan violates the generic constitutional and statutory proscriptions against wagering contracts and lotteries. The lower court's determination that the Plan's stock award provisions does not violate such proscriptions is included in Specifica- of Error 3.

New York Constitution, Article 1 Section 9

> "* * * no lottery * * * or any other kind of gambling, * * * shall hereafter be authorized or allowed within this state; and the legislature shall pass appropriate laws to prevent offenses against any of the provisions of this section."

Pursuant to this constitutional command the New York Legislature has declared unlawful any stake which is awarded dependent upon any chance, casualty or unknow or contingent event.

New York Penal Law, Section 991

> "All * * * stakes, made to depend * * * upon any lot, chance, casualty, or unknown or contingent event whatever, shall be unlawful."

New York Penal Law, Section 992

> "All contracts for or on account of any money or property, or thing in action * * * staked, as provided in the preceding section, shall be void."

The Penney stock is by virtue of the method of distribution in the Plan staked to be distributed depending on the chances of death, discharge and withdrawal of participants. Such casualties, unknown or contingent events determine not only to whom such stock is distributed, but also the amounts awarded each retiring participant.

Wagering is the broad generic evil of which lotteries constitute a "form or species." Lotteries generally involve greater numbers of persons and require that each participant have paid a consideration for the chance to receive a prize.

State v. Schwemler (1936) 154 Or. 533, 60 P. (2d) 938

In addition to the broad wagering prohibitions, the legislature also specifically proscribed lotteries.

New York Penal Law, Section 1370

"A lottery is a scheme for the distribution of property by chance, among persons who have paid or agreed to pay a valuable consideration for the chance, whether called a lottery, raffle, or gift enterprise or by some other name."

New York Penal Law, Section 1371

"A lottery is unlawful and a public nuisance."

New York Penal Law, Section 1386

"All contracts, agreements and securities given, made or executed, for or on account of any raffle, or distribution of any money, goods or things in action, so raffled for, or agreed to be distributed as aforesaid, shall be utterly void."

In so far as the Penney stock was purchased with the funds and earnings of participants during 1940 and

1941, consideration was paid for the property. In so far as such stock is distributed dependent upon the deaths, discharges and withdrawals of fellow participants, it is distributed according to chance.

The cases make it clear that these New York constitutional and statutory provisions are aimed at a generic evil and not some particular form of wagering or lottery.

Irving v. Britton (Com. Pleas, 1894) 8 Misc. 201, 28 N.Y.S. 529, 530

> "Gambling is the mischief against which the prohibition of the constitution is leveled; and it is 'the office of the judges to make such construction as will suppress the mischief and advance the remedy, and to suppress all evasions for the continuance of the mischief.' Magdalen College Case, 11 Coke, 66b-79a; Wilkinson v. Gill, 74 N.Y. 63, 67. The language of the constitution is generic, not specific; not one species of lottery, but all lotteries, are proscribed * * *. So, in Wilkinson v. Gill, 74 N.Y. 63, of 'any game or device of chance in the nature of a lottery,' the chief judge saying that 'the courts have uniformly looked beyond the mere form of the transaction and sought out and suppressed the substance itself.'"

At the trial counsel for defendants took the position that "the use [by the Trustee] of the contributions that came in from participants" was of no concern to participants who "would always be sure to get 100 per

cent of * * * [their] credits" when they left (Stone, R. 384-385) The cases have uniformly held, however, that a scheme is no less a lottery simply because participants are sure to receive back an amount equal to what they have paid.

Carl Co. v. Lennon et al (1914) 86 Misc. 255, 148 N.Y.S. 375, 376

Plaintiff, a clothing house, sold 500 small banks for 25 cents each upon a plan whereby the name of a purchaser was drawn each day and he became entitled to $1 worth of goods. Although the court considered the appeal to gambling instincts to be negligible, and that the scheme of selling banks for 25 cents "attract[ed] people to the store with the certainty of getting $1.25 worth of goods for 25 cents" (p. 377). Nevertheless, the scheme contained sufficient element of chance to be condemned as a lottery.

> "Payment for the bank is a consideration for the right to participate in the benefits of the scheme, although the bank is worth the money paid for it. Taylor v. Smetten, 11 Q.B.D. 207."

State ex rel Home Planners Depository v. Hughes (1923) 299 Mo. 529, 253 S.W. 229, 28 A.L.R. 1305

Relator was a trust which issued certificates requiring the holders thereof to pay $4 monthly for each $500

face value for a period not exceeding ten years. Certificate holders were eligible for loans, at 3 per cent interest, on real estate according to the time applications to secure certificates were signed. Those certificate holders who did not obtain loans and who completed their installments were entitled to receive back the amounts paid in plus a proportionate share of the profits. Despite this, the court quashed relator's alternative writ of mandamus to compel the commissioner of finance to license it, and held the scheme an illegal lottery. (253 SW at p. 230:

> "The first question argued is whether relator's plan or scheme is a lottery, or in the nature of a lottery, within the meaning of § 10 of article 14 of the Constitution, which forbids the authorization of lotteries or gift enterprises for any purpose. The term 'lottery,' thus used, includes every device whereby anything of value is, for a consideration, allotted by chance. State v. Becker, 248 Mo. loc. cit. 560, 154 S. W. 769; State v. Mumford, 73 Mo. 647, 39 Am. Rep. 532; 17 R. C. L. p. 1222, § 10. Consideration, chance, prize — these are the elements. That relator's plan includes the first cannot be denied. The questions debated relate to the second and third. *The fact that each certificate holder eventually might or would receive an amount equal to the aggregate of his payments can make no difference if, in addition, each secured a chance for a prize.* State v. Mumford, supra; State v. Lipkin, 169 N. C. 265, L.R.A. 1915F, 1018, 84 S. E. loc. cit. 343, Ann. Cas. 1917D, 137. * * * The loans it agrees to make to its certificate holders are to bear 3 per cent interest. The right to such a loan is obviously a valuable right." (Emphasis added)

Fitzsimmons v. United States (CCA 9, 1907) 156 Fed. 477

In holding a credit scheme to constitute an illegal lottery, the court stated on page 479:

> "To constitute a prize, the inequality need not necessarily be great, and the element of prize may exist in a scheme so arranged as to return to each participant something of value, or even an equivalent for all that he pays in."

Numerous other schemes have been subject to the lottery prohibitions regardless of the fact that participants were guaranteed a 100 per cent return in value for their contributions. Many such cases involved "suit clubs" in which participants made regular weekly payments until the full cost of a suit was paid. Each week, however, certain participants were entitled to receive their suits without further payment. Some paid for their suits in full, others obtained their suits after partial payments. Nevertheless, the schemes have been consistently held invalid.

Bills v. People (1945) 113 Colo. 326, 157 P. (2d) 139

People v. Hecht (1931) 119 Cal App 778, 3 P. (2d) 399

People v. Wassmus (1921) 214 Mich. 42, 182 N.W. 66

De Florin v. State (1905) 121 Ga. 593, 49 S.E. 699

The same scheme has been held illegal when used in the purchase of furniture,

State v. Emerson (1927) 318 Mo. 633, 1 S.W. (2d) 109

State v. Lipkin (1915) 169 N.C. 265, 84 S.E. 340

or when used in the purchase of jewelry.

People v. Bloom (1928) 222 App. Div. 451, 227 N.Y.S. 225, reversed on other grounds (1928) 248 N.Y. 582, 162 NE 533

In the Penney Plan the stock was the prize; the survival of participants with the Company until age 60, the chances, casualties, unknown and contingent events upon which stock awards depended, and the contributions and earnings of participants applied to liquidate the loan used to purchase the stock prize, the consideration.

B. The Nature of the Scheme for Awarding Stock, not the Alleged Good Intentions of the Sponsors, Determines Whether or not it Constitutes a Tontine Contract, Wagering Contract or Lottery.

Upon the trial, appellees sought to introduce, through the testimony of A. W. Hughes, President of the Company, evidence that the stock award provisions were included in the Plan because of "sound business judgment" (R. 357), "done in good faith for a valid

business purpose" (R. 357). The entire line of testimony was objected to by appellants (R. 355-9) on the grounds that it was an attempt to vary the written Plan and that it was immaterial to any issue raised in the pre-trial order. Counsel for appellees conceded that the illegality of the Plan, if any, could be determined from the Plan itself (R. 357).

Counsel for appellees then advanced the proposition that a scheme which "may be a lottery under certain circumstances is not a lottery if it was done in good faith for a valid business purpose" (R. 357) and that appellees "have a great deal of authority to support * * * [them] on that." (Young, R. 357) Because of this assurance that "there will be ample authority submitted to support that contention" (Young, R. 358) the court agreed to admit such evidence "provisionally" (R. 357) The admission and consideration of such evidence (R. 396) are the grounds of Specification of Error 4.

Subsequently, counsel for appellees referred to his assurance of authority that a "valid business purpose negatives the matter of a lottery" (Young, R. 393) and submitted the following authority:

12 Am. Jur. 744, *Contracts*, Section 224

> "* * * there is a presumption in favor of the legality of an agreement, and although an agreement is illegal, if the illegality does not appear on

> its face it must be proved by the person who asserts it. The rule is established that where a written instrument is attacked upon the ground that the agreement is offensive to law and violative of public policy the whole transaction should be inquired into, and the Court will not expect itself to be embarrassed by any technical rules regarding the admissibility of evidence." (R. 395)

Counsel for appellees failed, however, to read to the court the remaining sentence in that section of Am. Jur.:

> "Where, however, a written agreement is plain and unambiguous and by its terms illegal, it has been said that parol evidence is not admissible for the purpose of purging the agreement of its illegality."

In the first place, even the truncated part cited by appellees is not relevant. The sentence of the citation that "the Court will not expect itself to be embarrassed by any technical rules regarding the admissibility of evidence" refers solely to an attempt to protect an illegal transaction from exposure by extrinsic evidence. The one case cited thereto states that proposition.

Kuhn v. Buhl (1916) 251 Pa. 348, 96 Atl. 977

In that case the person alleging the *illegality* was attempting by parol evidence to show illegal a transaction valid on its face. The other cases cited in the

same section of American Jurisprudence support the same obvious proposition, but not one case even suggests that any type contract invalid on its face may be saved by extrinsic evidence. Indeed, the cases concerning wagering contracts and lotteries hold quite the contrary; that the dominant purpose of a lottery scheme is a legitimate business one does not lessen its illegality.

Carl Co. v. Lennon (1914) 86 Misc. 255, 148 N.Y.S. 375, supra, p. 50

In this case the court held the scheme of selling banks for 25 cents a "harmless piece of advertising to attract people to the store with the certainty of getting $1.25 worth of goods for 25 cents" (p. 377). Despite the fact that the court considered the appeal to gambling instincts to be negligible, and the scheme to involve "no ill effects," it was held to be a lottery.

People v. Lavin (1904) 179 N.Y. 164, 71 N.E. 753, 754, reversing (App. Div. 1904) 87 N.Y.S. 776

In this case the purchaser of a cigar was entitled, with the band, to compete for prizes. That the scheme had a dominant business purpose was declared irrelevant:

> "But the prohibition and regulation of gambling in all forms and lotteries of every kind are unquestionably valid exercises of legislative power, and, if the scheme established by the advertiser was, in effect, a lottery, the fact that the dominant purpose

was merely to increase the advertiser's business does not save it from condemnation."

The fact that the Penney Plan stock feature was intended for the "interest of the Penney Company and all, every possible or prospective participant" (Hughes, R. 367) would not affect its identity as a wagering scheme. The very same claim, that a scheme for discounting furniture installment contracts was operated best to "help the company," has been held not to save it from condemnation as a lottery.

State v. Emerson (1927) 318 Mo. 663, 1 S.W. (2d) 109, supra, p. 53

In an early case a scheme in which penny candy was sold with numbers, the purchasers of which might be entitled to a prize, was struck down as a lottery despite its innocence of character and effect.

People v. Runge (1885) 3 N.Y. Crim. 85

Even the most worthy of causes will not justify gambling or lotteries. The firmness of this principle may be seen from a recent New York case concerning bingo.

People v. Kiefer (1940) 173 Misc. 300, 16 N.Y.S. (2d) 858

In this case the court refused to dismiss indictments of three men who operated a bingo game for the benefit

of the Society for the Prevention of Cruelty to Children in the county of Queens. Between 1,000 and 1,500 "decent residents * * * derived pleasure * * * for 25 cents, or slightly more" from a game, none of which was "harmful to any participant" nor "deprived anybody of any of the necessities of life" (p. 861).

The court's personal attitude toward innocent bingo was clear:

> "* * * I can foresee the Madison Square Garden Bowl in Queens County crowded with 60,000 people or more, once in the spring and again in the fall, participating in a monster bingo, the great proceeds of which could be beneficially used in providing iron lungs, oxygen tents and modern surgical equipment to the hospitals of our county, so that their patients could obtain surcease from their sufferings."

Nevertheless, despite his reluctance, the court held:

> "* * * that in every instance where a bingo is conducted those conducting the same are violating the law * * * ." (p. 862)

In this holding, the court was consistent with previous holdings of the court. Thus, a numbered ticket to a "grand concert," entitling the holder to whatever gift would be awarded, was illegal, and the "worthiness and excellence of the charties, * * * [did] not remove the vice from the enterprise, or make it lawful and proper."

Negley v. Devlin (1872) 12 Abb. Prac. (N.S.) 210, 212

The same reasoning was employed in holding illegal a scheme whereby members of an art group contributed $5 and received a chance to win some pictures.

Alms House v. American Art Union (1852) 7 N.Y. 228

The same reasoning has also been applied to tontine insurance schemes which have been invalidated. In brushing aside all questions other than the nature of the scheme, courts have declared irrelevant the attitude and consent of participants and promoters (see *Fuller v. Metropolitan Life Ins. Co.*, supra, p. 41). The members of the governing group which devised the Penney Plan testified to their awareness of the hazard involved in not getting stock if they failed to continue with the Company until age 60. They further testified that they were willing to accept such contingencies (Schwamb, R. 273; Herbert, R. 275; Hughes, R. 302). Even though the chances assumed by these top men did not, of course, include the same hazards of discharge borne by the other participants, their willingness to assume the contingencies of death, though relevant to the fact that they were aware of the tontine features of the Plan when adopting it, is irrelevant to the question of whether or not the scheme is invalid.

State ex rel Attorney General v. Interstate Sav. Inv. Co. (1901) 64 Ohio St. 283, 60 N.E. 220, 231

> "The question here is not whether the promoters of the defendant company have intentionally devised a scheme to mislead and defraud, but whether that is the effect of it. The promoters and the investors may be self-deluded or satisfied to take the chances offered, but that does not alter the character of the scheme. If the company is misusing its corporate privileges in such a way as to be a public abuse, the writ must issue, regardless of the intent."

Even if the illegality of the Plan could not be ascertained from the Plan itself and extrinsic evidence were admissible, the uncommunicated retrospective self-serving declarations of Penny officials would in any event be irrelevant and inadmissible.

3 *Corbin on Contracts* 77-78, Section 543

> "A party will not be permitted to build up his case by self-serving statements; they should be admissible against him, however, as admissions against his interest. They are admissible to aid in showing that he knew or had reason to know the meaning that the other party gave to the words of the contract."

II. THE TRUSTEE HOLDS THE SHARES OF STOCK UNDER A RESULTING TRUST FOR THOSE WHOSE CONTRIBUTIONS AND EARNINGS WERE USED IN THEIR PURCHASE.

A. The Assets of a Trust, or any Part Thereof, Which is Illegal and Void, are Held in a Result-

ing Trust for Those who Contributed to the Trust.

When a trust, or any part thereof, is found to be illegal and void, the Trustee holds the assets in a resulting trust for those who contributed thereto. Specifications of Error 5 attacks the failure of the District Court to declare the shares of stock to be held by the Trustee under a resulting trust in favor of appellants. Specification of Error 7 challenges the District Court's conclusion that it would be inequitable for such stock to be distributed to those whose earnings and contributions were used for the purchase of said stock.

When assets have been illegally staked in a wagering contract or lottery, specific statutory provisions not only provide for but also encourage recovery by the contributors.

New York Penal Law, Section 994

> "Any person who shall pay, deliver or deposit any money, property or thing in action, upon the event of any wager or bet prohibited, may sue for and recover the same of the winner or person to whom the same shall be paid or delivered, and of the stakeholder or other person in whose hands shall be deposited any such wager, bet or stake, or any part thereof, whether the same shall have been paid over by such stakeholder or not, and whether any such wager be lost or not."

New York Penal Law, Section 1383

> "Any person who shall have paid any money, or valuable thing, for a chance or interest in any raffle or distribution, prohibited by the preceding sections, may sue for and recover the same of the person to whom such payment or delivery was made."

These statutes are remedial rather than penal, are construed liberally to permit recovery and have specifically eliminated the former defense of in pari delicto.

Galtrof v. Levy (1940) 174 Misc. 489, 21 N.Y.S. (2d) 455, motion to amend answer denied (1940) 174 Misc. 1004, 22 N.Y.S. 2d 374

Stuart v. Grattan (1926) 217 App. Div. 336, 216 N.Y.S. 727

Mendoza v. Levy (1904) 98 App. Div. 326, 90 N.Y.S. 748

The right of recovery is so strongly recognized that a bankrupt has been refused discharge because the trustee had failed to recover the losses from casual bets made by the bankrupt with a professional better.

Klein v. Morris Plan Industrial Bank of N.Y. (CCA 2, 1942) 132 F. (2d) 809

Recovery may be had even though the loser may have specifically consented to the payment by the stakeholder to the winner.

Ruckman v. Pitcher (1848) 1 N.Y. 392

> "The evident intention of the legislature was to discourage and repress gaming in all its forms, including bets and every species of wager contracts of hazard, as a great public mischief, calling for effective measures of prevention and remedy."

The policy permitting recovery of staked property is so strong that a person may recover even though his other "winnings" exceeded the losses for which recovery was claimed.

Watts v. Malatesta (1933) 262 N.Y. 80, 186 N.E. 210

Even a habitual gambler has been permitted to recover his losses.

Bamman v. Erickson (1942) 288 N.Y. 133, 41 N.E. (2d) 920, 922

> "It [the law] does not treat alike the spider who spins the web and the fly enmeshed in it."

This parable would seem highly appropriate to the present action. Appellants at no time from the inception of the Plan until their employment with the Company terminated had been advised of the illegality in this stock feature of the Plan (Wells, R. 310) (Albertsen, R. 318) (see also Mitchell, R. 338). Appellants, along with "every [other] manager on contract and every partici-

pant in the general office compensation plan had to either sign an acceptance card for the Plan or cease active continuance of the duty he had" (Hughes, R. 302).

In contrast, the Company officials who drafted and adopted the Plan were well aware of the hazards inherent in the Plan which constitute its illegal features. Not only were they fully aware of these aspects of the Plan, but willingly accepted the hazards involved (Schwamb, R. 273; Herbert, R. 275; Hughes, R. 302).

Apart from these statutory remedies, courts declare void provisions of a trust which violate public policy.

1 *Scott on Trusts* 376, Section 62

> "There is a large and miscellaneous class of trusts which are held invalid on the ground that their enforcement would be against public policy, even though the enforcement does not involve any criminal or tortious act by the trustee. On the same ground a provision in the terms of the trust may be illegel, even though the trust itself does not fail for illegality."

54 Am. Jur. 38, Trusts, Section 21

Where the trust fails for such reasons, a resulting trust arises in favor of those who furnished the consideration for the creation of the trust.

3 *Scott on Trusts* 2204-2205, Section 422A

"Where an express trust fails a resulting trust arises in favor of the person who created the trust or his successors in interest. Who, then, is the person who creates the trust? Where an owner of property devises it or bequeaths it in trust, the testator is the creator of the trust, and if the trust fails a resulting trust arises in favor of his heirs or next of kin or residuary devisees or legatees. Where the owner of property gratuitously transfers it inter vivos upon a trust which fails, he is the creator of the trust and a resulting trust arises in his favor. The situation is different where consideration is paid for the transfer in trust. If the consideration is paid by the transferee, he is the creator of the trust, and if the trust fails he is entitled to hold the property free of trust. If a third person pays consideration for a transfer in trust, he is the creator of the trust, and if the trust fails a resulting trust arises in his favor."

3 *Scott on Trusts* 2206-2207, Section 424

"Where an owner of property transfers it upon a trust which fails, and the consideration for the transfer was paid by a third person, a resulting trust arises not in favor of the transferor but in favor of the person who paid the consideration. In such a case the transferor is simply a vendor of the property. The person who pays the consideration being the real creator of the trust, there is a resulting trust in his favor on the failure of the trust."

2 *A.L.I., Restatement, Trusts* 1311, Section 424

"Where the owner of property transfers it upon a trust which fails, and he receives from a third per-

son consideration for the transfer as an agreed exchange, there is a resulting trust in favor of the person who paid the consideration."

1 *Bogert, Trusts and Trustees* 270, Section 41

1 *Perry on Trusts and Trustees* (6th Ed.) 239, Section 151

Paragraph Nineteenth of the Agreement of Trust (R. 72) provides that it shall be considered and enforced according to the laws of New York. A resulting trust of personal property is valid and enforceable under the laws of New York.

Coleman v. Mulligan (1945) 66 N.Y.S. (2d) 696, 697

2 *Bogert, Trusts and Trustees* 1435, Section 467

Cases dealing with illegal tontine accumulations have ordered pro rata distribution to those who contributed thereto.

United States Life Ins. Co. v. Spinks (1906) 29 Ky. L. 960, 96 S.W. 889, petition for rehearing overruled (1907) 126 Ky. 405, 103 S.W. 335, appeal dismissed (1908) 209 U.S. 539, 52 L Ed. 917 supra p. 43

In this case the court applied Mr. Spinks' equitable share of the tontine accumulations to extend his policy with paid-up insurance.

State ex rel Attorney General v. Interstate Savings Inv. Co. (1901) 64 Ohio St. 283, 60 N.E. 220, supra p. 60

After indicating that a tontine contract was an illegal lottery, the court stated (p. 233):

> "It should be added, as the opinion of the whole court, that it is the duty of the state treasurer to hold and distribute the fund deposited with him in trust for the holders of the debentures in this state according to the amount that may be found due to each one."

The Penney Plan is challenged in this action as to the stock provisions alone. A trust may be invalidated as to illegal provisions and upheld as to valid provisions, and courts will make such severance whenever possible.

3 *Scott on Trusts* 2177, Section 411.2

> "A resulting trust arises not only where an intended trust fails altogether, but also where it fails in part. Where the intended trust fails in part, there is a resulting trust of so much of the property as is not appropriated to the part of the trust which does not fail."

Hawthorne v. Smith (1937) 273 N.Y. 291, 7 N.E. (2d) 139

1 *Scott on Trusts* 405, Section 65.1

1 *A.L.I. Restatement of Trusts* 204, Section 65

1A *Bogert on Trusts* 315, Section 211

This failure may arise from illegality.

3 *Scott on Trusts* 2196, Section 422

A policy with a tontine feature may be invalidated as to that part without affecting the remaining valid portions.

Wheeler v. Mutual Reserve Fund Life Ass'n. (1902) 102 Ill. App. 48

In a very recent case involving a retirement pension plan, an illegal portion thereof was severed from the valid portions.

Ledwith v. Bankers Life Ins. Co. (1952) 156 Neb. 107, 54 N.W. (2d) 409, 417

In this case, policyholders of the defendant insurance company sued in equity to obtain an adjudication that a company retirement plan, insofar as it included officers, was illegal under Nebraska law, and that the amounts set aside therefor be held illegally appropriated and be restored.

The court discussed the statutes governing retirement plans and stressed the compensatory nature required of such plans.

> "The retirement plan of the company and the benefits thereunder are a form of contingent deferred compensation for personal services of the em-

ployees and an integral part of the wage and salary structure of the company. The benefits provided by the plan constitute 'salary, compensation or emolument' as these terms are used in the statute. This is conceded by appellees. These characteristics of a retirement plan have been recognized and established by judicial decisions. Inland Steel Co. v. National Labor Relations Board, 7 Cir., 170 F. 2d 247, 251, 12 A.L.R. 2d 240, adopted and approved the ruling of the defendant board that: ' "* * * the term 'wages' as used in Section 9 (a) [29 U.S.C.A. § 159 (a)] must be construed to include emoluments of value, like pension and insurance benefits * * *. Realistically viewed, this type of wage enhancement or increase, no less than any other, becomes an integral part of the entire wage structure * * *." ' "

In analyzing the statutes, the court concluded that officers of the insurance company were "not employees within the meaning of the statute authorizing the company to establish and administer a retirement plan for the benefit of its employees" (p. 419). The lower court had dismissed the complaint. The Supreme Court reversed with instructions to the lower court to invalidate the plan only to the extent that its provisions were illegal.

"The judgment should be and is reversed with directions to the district court of Lancaster County to render a judgment in this case as follows: That the retirement plan of the Bankers Life Insurance Company of Nebraska involved herein is, and has been at all times, unauthorized and invalid in the respect and to the extent that it provides that the

> officers of the company are included in the plan and its benefits; that any provision thereof intended to bring any officer of the company within the coverage or benefits of the plan is, and has been since the adoption of it, invalid and such provision is vacated and annulled; that the retirement plan for the benefit of the employees of the company is legal and effective; and that appellees be directed and required to return, restore, and pay to the company and to the proper fund or funds thereof all assets and money set aside, appropriated, or expended for, or on account of, the retirement plan including cost and expense because of the inclusion of the officers of the company in the coverage of the plan." (p. 424)

Despite this authority, the District Court found that the stock provisions of the Penney Plan are unseverable from the remaining portions. This is challenged by Specification of Error 6. However, the illegality of the stock provisions inheres in the Plan, whether or not those provisions are separable. Therefore, assuming that the stock provisions are inseparable, the necessary result would be the termination of the entire Plan.

B. The Stock was Purchased With the Contributions and Earnings of those persons who were participants in the Plan during 1940 and 1941.

Previously it has been shown that the loan used to purchase the stock was fully repaid with the contributions and earnings of participants by December 29, 1941

(supra, pp. 8-12). At that time participants had absolutely vested claims against the Trust totaling $4,975,668.21, while to satisfy these obligations the Trustee held only $389,565.61 in cash and 200,000 shares of Penney stock, supra, p. 9.

The full extent of the interest in the stock held by the 1940-1941 participants may be appreciated most graphically by considering what would have happened had the Plan been terminated on December 29, 1941, when the stock became an unencumbered asset of the Trust. Article 24 of the Plan specifies that on termination the amount of credits due participants be determined (R. 36). These credits totaled $4,975,668.21 on December 29, 1941, and were derived from the following sources:

Participants' direct contributions on which they paid income tax	$4,041,769.28
Profit-sharing contribution under 6 (b)	371,931.56
Amount credited to dividend account after cost of 50,000 share block was covered (R. 138)	561,967.37
Total	$4,975,668.21

Then the ratio which the market value of the Fund's assets (exclusive of the stock) bears to these credits must be determined. Those assets totaled $389,565.61 in cash, and each participant on receiving his share of this cash would have received less than 8 cents for each

dollar to his credit. For the remaining 92 cents on the dollar, participants would have had to look to the stock.

Of the funds used to repay the loan, it has already been shown, supra, p. 8, 65 per cent were direct contributions by participants from earnings on which they had already paid income tax, 27.4 per cent were from earnings of the Fund, 6.0 per cent were from the profit-sharing contributions, and 1.6 per cent were from the 2 per cent aggregate salaries contributions. All these contributions constituted earnings of participants, including the profit-sharing contributions and the 2 per cent of aggregate salaries contributions.

Under New York law a corporation may not pay bonuses or pensions to employees over the protest of any shareholder (60,561 shares were voted against the Penney Plan, Exhibit 1) unless such payments constitute compensation in relation to services rendered.

Diamond v. Davis (N.Y. Supreme Ct., 1942) 38 N.Y.S. (2d) 103, 113; affirmed (1944) 292 N.Y. 552, 54 N.E. (2d) 683; also (N.Y. Supreme Ct., 1945) 62 N.Y.S. (2d) 181

Gallin v. National City Bank (1934) 152 Misc. 679, 273 N.Y.S. 87; (1935) 155 Misc. 880, 281 N.Y.S. 795

Rogers v. Hill (1933) 289 U.S. 582, 77 L. Ed. 1385

Employer contributions to bonus or pension plans are upheld only when constituting reasonable compensation to the beneficiaries.

Parsil v. Onyx Hosiery, Inc. (1927) 220 App. Div. 148, 221 N.Y.S. 174, affirmed (1927) 246 N.Y. 559, 159 N.E. 651

Fogelson v. American Woolen Co. (C.A. 2, 1948) 170 F. (2d) 660

J. C. Penney Company is incorporated in the state of Delaware (R. 92) and its corporate powers are governed by the laws of that state. Under Delaware law, a majority of stockholders may neither authorize nor ratify a corporation's making *gifts* to a pension plan. Contributions to a pension plan, in the absence of unanimous stockholder consent, are limited to those which constitute reasonable compensation to participants.

Nemser v. Aviation Corp. (D. Del., 1942) 47 F. Supp. 515

The Retirement Plan was expressly devised as a substitute for previous sales of "expansion stock" and "partnership" arrangements prior to that (Exhibits 2 and 55). The Retirement Plan differed from the profit-sharing aspects of participants' regular compensation in giving manager-participants an interest in the wel-

fare of the entire Company, rather than in one store only (R. 362). The stock feature was "set * * * up as an incentive so that a man would strive constantly, particularly as he approached retirement age, to lift higher, hoping to increase his earnings, and therefore, increasing the contribution to the retirement fund and the annuity in the stock he might get at the end of it" (R. 366). When questioned by the court, counsel for the Company concurred that the Plan was an inducement for employees to continue with the Company (R. 388).

It may be recalled that the Company could, while the Plan was in effect, discharge a store manager or any other participant without cause (R. 178). Numerous cases have held that bonus pension provisions established to induce employees to remain with and contribute loyally to the Company constitute a form of compensation to such employees.

Gearns v. Commercial Cable Co. (1942) 177 Misc. 1047, 32 N.Y.S. (2d) 856, 858, aff'd (1943) 266 App. Div. 315, 42 N.Y.S. 2d 81, aff'd. (1944) 293 N.Y. 105, 56 N.E. 2d 67, rehearing denied (1944) 293 N.Y. 755, 56 N.E. 2d 749

Plaintiff had been retired under a pension plan which reserved to employer the right to alter the plan provided such change did not prejudice the rights of

an employee entitled to benefits. Speaking of this provision, the court stated (32 N.Y.S. (2d) at p. 858):

> "Even in the absence of such a provision, it is doubtful if defendant arbitrarily could have refused payment as the plan was not merely a benefaction but a contract supported by plaintiff's consideration of continued services under the plan and his acceptance of other obligations under it. McLemore v. Western Union Telegraph Co., 88 Or. 228, 171 P. 390; Western Union Telegraph Co. v. Hughes, 4 Cir., 228 F. 885; McNevin v. Solvay Process Co., 32 App. Div. 610, 53 N.Y.S. 98; Schofield v. Zion's Co-op Mercantile Institution, 85 Utah 281, 39 P. 2d 342, 96 A.L.R. 1083."

Wilson v. Rudolph Wurlitzer Co. (1934) 48 Ohio App. 450, 194 N.E. 441, 443

Employer announced a plan whereby at employer's sole expense pensions were to be paid on retirement based upon years of service (minimum 10 years (and wages earned. Plaintiff, who was entitled to a pension, was refused one because he was discharged for failure to comply with request for work at night. On page 443 the court stated:

> "It is plain that the pension plan was an integral part of the program for his employment. * * * This provision constituted a continuing part consideration for the services rendered by the employee. It was a daily inducement to continuation of service and to exertion to satisfy, which was successful for more than twenty-four years.

"The fact that the employment was subject to the will of both parties only makes the character of the inducing provisions more binding upon the employer." (Emphasis added)

Tilbert v. Eagle Lock Co. (1933) 116 Conn. 357, 165 Atl. 205, 207

Perkins v. Eagle Lock Co. (1934) 188 Conn. 658, 174 Atl. 77 (Involved same plan as Tilbert case, supra)

Robinson v. Standard Oil Co. (La., 1938) 180 So. 237, 239

Moore v. Postal Telegraph-Cable Co. (1943) 202 S.C. 225, 24 S.E. (2d) 361, 364

Schofield v. Zion's Co-op. Mercantile Institution (1934) 85 Utah 281, 39 P. (2d) 342

McLemore v. Western Union Telegraph Co. (1918) 88 Or. 228, 171 Pac. 390

Mabley & Carew Co. v. Borden (1935) 129 Ohio St. 375, 195 N.E. 697

Psutka v. Michigan Alkali Co. (1936) 274 Mich. 318, 264 N.W. 385

H. S. Kerbaugh, Inc., v. Gray (CCA 2, 1914) 212 Fed. 716

George A. Fuller Co. v. Brown (CCA 4, 1926) 15 F. (2d) 672, 675-676

In the plans considered in the foregoing cases, the employer advanced all the funds. In the Penney Plan, the employer advanced only 7.6 per cent of the funds contributed to the Trust during 1940 and 1941. The above

cases demonstrate, however, that even these funds were a form of compensation to participants.

The profit-sharing contribution under Section 6 (b) of the Plan and the 2 per cent of aggregate salaries contributions under Section 6 (a) of the Plan are "treated as though they were in the Fund at the end of the year in which * * * earned." "Company contributions are credited to participants' accounts on this accrual basis" (R. 146). At the end of each year as such contributions are accrued, they become vested compensation earned by participants.

Roberts v. Mays Mills (1922) 184 N.C. 406, 114 S.E. 530, 532

> "In Youngsberg v. Lamberton, 91 Minn. 100, 97 N. W. 571, the court held that, where one party agreed to render service to the other for a year for a fixed salary, and received as a bonus a percentage of the business of his employer at a specified time, the employee, if discharged, had a right of action accrued up to that time for the profits or bonus earned."

Because contributions to a retirement plan are compensation "presently earned," issuance of a writ of mandamus was affirmed to compel commissioners to make a required annual payment to a retirement fund.

Retirement Board of Allegheny County v. McGovern (1934) 316 Pa. 161, 174 Atl. 400

McBride v. Retirement Board (1938) 330 Pa. 402, 199 Atl. 130

This latter case relies on the McGovern case and also on two New York cases:

Roddy v. Valentine (1935) 268 N.Y. 228, 197 N.E. 260
Graef v. Department of Health (1928) 131 Misc. 258, 227 N.Y.S. 82

Consistent with this substantive state law (that these contributions were the earnings of participants at the end of the year in which accrued) is the manner in which the Company deducted these payments as a business expense under Section 23 (p) (1) of the Internal Revenue Code (all references are to the 1939 Code) and under New York Tax Laws, Section 365, and New York State Tax Commission, Reg. Art. 119-a and 117. Deductions are not permitted under I.R.C., Section 23 (p) (1) unless they are necessary and reasonable business expenses within the meaning of Section 23 (a) (Reg. 118, Section 39.23 (p)-1 (b)), and they are necessary and reasonable only insofar as they constitute reasonable compensation to the employees.

Charles E. Smith & Sons Co. v. C.I.R. (C.A. 6, 1950) 184 F. (2d) 1011; cert. den. (1951) 340 U.S. 953, 95 L. Ed. 687

Mim. 6021, May 29, 1946, 1946-2 CB 43

Thus, under state substantive law and under federal and state tax law, all the funds used by the Trustee to purchase the Penney stock were the earnings of participants at the end of each year in which accrued. Because the provisions of the Plan regarding the shares of Penney stock are illegal and void, the Trustee holds said stock in a resulting trust for the 1940-1941 participants whose contributions and earnings were used for the purchase thereof.

CONCLUSION

Appellants pray that the judgment of the District Court be reversed, and that judgment be entered declaring that the Plan, in so far as it relates to the Penney stock, is invalid under New York law and public policy, and that the Trust as to said shares is void and of no effect.

Appellants pray that the action thereafter be remanded to the District Court to supervise the administration of the resulting trust in said shares of stock for distribution to appellants and other participants, former and present, in proportion as their contributions and earnings were used for the purchase of such stock.

Appellants further pray that on remand the District Court be directed to award appellants compensation for

the reasonable value of the services of their attorneys in the prosecution of this action, and for their costs and disbursements incurred herein (Specification of Error 8).

Respectfully submitted,

King, Miller, Anderson,
Nash & Yerke

Ralph H. King

Frederic A. Yerke, Jr.

Paul R. Meyer

Attorneys for Appellants